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# In the Supreme Court of the United States

OCTOBER TERM, 1962

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No. 959

AMOR F. PIERCE and IDA MAE PIERCE, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### OPINIONS BELOW

The findings of fact and opinion of the Tax Court of the United States are reported at 37 T.C. 1039 (R. 36-48). The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 311 F. 2d 894 (Pet. 19-20).

### JURISDICTION

The judgment of the court of appeals was entered on December 28, 1962 (Pet. 21). The petition for a

writ of certiorari was filed on March 28, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## QUESTION PRESENTED

Where an annuity-purchase transaction was lacking in economic substance, so that interest payments made in connection therewith were non-deductible in the taxable year when made, can the taxpayer by payments made six years later impart retroactive substance to the transaction and thus render the interest payments deductible?

## STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C. 163):

> SEC. 163. INTEREST.
>
> (a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.
>
> * * * *

## STATEMENT

The material facts as found by the Tax Court (R. 36-46) and as stipulated by the parties (R. 11-35) may be summarized as follows:

On December 13, 1954, the taxpayer, Amor F. Pierce,[1] applied to All Service Life Insurance Corporation for six deferred annuity contracts. The total

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[1] Ida Mae Pierce is involved herein merely because she filed a joint income tax return with her husband.

consideration was $600,000, payable in six annual installments of $100,000. All Service accepted taxpayer's non-recourse six percent demand promissory note in the face amount of $100,000 on December 13, 1954, as payment of the first annual consideration, and issued to him six deferred annuity contracts dated December 1, 1954. (R. 37.)

Taxpayer was then able to borrow $117,441 on the annuity contracts because the net loan value was computed as of December 1, 1960, the date to which taxpayer had agreed to pay interest in advance for the "loan." He borrowed the full amount on December 28, 1954, and applied the proceeds first to the payment of the $100,000 non-recourse demand note which taxpayer had delivered in payment of the first annual consideration. (R. 38-39.)

Taxpayer then paid All Service $24,718 as interest on the loan of $117,441 for six years in advance, at the rate of 3.75 percent per annum (with interest paid for more than one year in advance discounted at the rate of 2.75 percent per annum), compounded annually. Taxpayer paid $17,441 of such interest out of the remaining proceeds from the loan of $117,441. (R. 39.)

As of the end of 1954, according to the books and records of All Service, the net cash value (after adjusting for loans, prepaid interest, etc.) of the six annuity contracts was $5,520. Taxpayer's out-of-pocket cost for the six annuity contracts as of the same time was $7,277, the difference between the $124,718 payment made as interest and premium and the $117,441 borrowed from All Service. But for tax

considerations, taxpayer's purported investment in the six annuity contracts resulted in a net economic loss of $1,757 ($5,520 net cash value minus $7,277 net cost) in 1954. (R. 39-40.)

On their joint federal income tax return for the calendar year 1954, taxpayers claimed a deduction in the amount of $24,718 as interest paid to All Service. The Commissioner disallowed this deduction. (R. 40.)

In December of each of the following five years, additional new loans were made with the annuity contracts being assigned as the sole collateral security therefor and $100,000 of the proceeds of such contract loans was applied each year, either to the payment of promissory notes which had been tendered in payment of the annual consideration then due, or directly to the payment of the annual consideration then due. The remaining balance of the loan proceeds was delivered to taxpayer. In December, 1960, the taxpayer borrowed an additional $20,202. In each of the years from 1955 through 1959, taxpayer paid interest on the then existing indebtedness for one additional year in advance and on the newly created indebtedness for five or six years in advance. (R. 40-41.)

The total outstanding indebtedness secured by the six annuity contracts as of the end of 1960 was $754,904.04. The net cash value of the six annuity contracts, including the net refundable interest paid in advance on contract loans, was $30,878 as of the end of 1960. (R. 41.)

Some few weeks prior to February 20, 1961, taxpayer met with the president of All Service, Robert

Dixon Wood, and discussed and reviewed taxpayer's position with respect to the annuity contracts. The present litigation, which had been continued by stipulation pending the decision in *Knetsch* v. *United States*, 364 U.S. 361, was discussed at that time, and taxpayer expressed a desire "to put some substance into the contracts" by making some additional payments. Taxpayer concluded that an additional investment would have a favorable effect on the present litigation. (R. 42.) Within the following six weeks, taxpayer repaid $190,620.07 of the loans, and applied $43,722 of prepaid interest which was refundable by reason of this prepayment to further reduction of the indebtedness. At that time, and until the date of trial of the present case shortly thereafter, the outstanding indebtedness secured by the six annuity contracts was approximately $520,562, and the net cash value of the six annuity contracts, including the net refundable interest paid in advance on contract loans, was approximately $220,140. (R. 43-44.)

Sometime during the period February 20, 1961, to March 28, 1961, for the first time the annual increase in the net cash value of the annuity contracts began to exceed the annual interest charges on the indebtedness secured by the contracts (R. 44).

The Tax Court found that in 1954 taxpayer's purported purchase of the six annuity contracts from All Service, his borrowing of funds from All Service, and the payment and prepayment of interest to All Service on such borrowing had no economic or commercial substance apart from an intended tax benefit (R. 45-46). The Tax Court concluded that the

purported loan repayments to All Service in 1961, shortly after the *Knetsch* decision, did not "impart retroactive vitality to a transaction that was a sham in 1954." (R. 47.)

The court of appeals agreed with the Tax Court that this case is controlled by the *Knetsch* decision, and that the transaction lacked economic significance to the extent it purported to have created an indebtedness in 1954. Accordingly, the findings and opinion of the Tax Court were affirmed *per curiam*. (Pet. 19-20.)

## ARGUMENT

The decision below was clearly correct. There is no conflict of decisions or any other reason for review by this Court.

1. The result in this case is controlled by *Knetsch* v. *United States*, 364 U.S. 361, which involved the same basic facts. In the *Knetsch* case, a high-bracket taxpayer attempted to create large income tax deductions at the expense of a small net cash outlay in connection with the purported purchase of an annuity from an insurance company. In form, the insurance company lent the taxpayer the amount necessary to purchase the annuity on a non-recourse note. By prepaying the interest on the loan, taxpayer increased the cash or loan value of the contract to permit additional borrowing by him. The net effect of the transaction was that the taxpayer drained off substantially all economic value from the contract and sustained a before-taxes economic loss while staking a claim to a large income tax deduction for "interest."

This Court characterized the alleged benefits of the annuity contract in *Knetsch* as a "fiction" and the amounts "ostensibly 'lent' * * * [a] rebate of * * * the so-called 'interest' payments" (364 U.S. at 365-366). Accordingly, the Court ruled that a transaction so utterly lacking in non-tax economic substance could not give rise to an income tax deduction as "interest * * * on indebtedness" within the meaning of the statute. Taxpayer in the instant case makes no real claim that his case differs from *Knetsch* as of the taxable year 1954, which should be dispositive of the petition.[2]

2. The crux of taxpayer's argument is that both courts below improperly refused to rule upon the question whether the increase in net cash value of his annuity contracts resulting from payments which he made in 1961 constituted a sufficient alteration in his beneficial interest to avoid the impact of the *Knetsch* decision in respect to the "interest" deduction which he claims for 1954 (Pet. 2, 7-9). Clearly, however, both courts below did pass upon this novel contention, the court of appeals echoing the observation of the Tax Court that these payments, made with a view to influencing the outcome of this case, could not "im-

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[2] The distinction sought to be made by way of a footnote (Pet. 7-8) is based principally upon what took place more than six years later. Taxpayer makes the unsupported statement that the loans here were with recourse, as contrasted with those in *Knetsch*. However, the terms of the note and loan agreement (Exhibits 3-C and 5-E in the Tax Court) are such that it is apparent that taxpayer could never have been held personally liable on them.

part retroactive vitality" to a transaction lacking substance in 1954 (Pet. 20).[3]

The basic infirmity in taxpayer's argument is that, under the annual accounting principle, each taxable year is treated as a separate unit, and it is necessary that each item of income or expense be reflected in terms of its posture at the end of the year. *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 384. In the *Knetsch* case, which involved the taxable years 1953-1954, the Court mentioned the taxpayer's activities in 1955-1956 "to complete the story of the transaction" (364 U.S. at 364), but when this Court turned to an evaluation of what was done in terms of economic substance, its examination was expressly confined to the taxable years involved (364 U.S. at 365-366). Even if this Court there intended to modify the fundamental rule that tax liabilities are determined on the basis of facts known or knowable at the close of the year—as it clearly did not—this taxpayer would not be aided, inasmuch as his transaction with the insurance company lacked substance not only in 1954 but also in the six succeeding years (Pet. 20).

Although taxpayer speculates that perhaps his actions more than six years later were disregarded by the courts below because he had a "bad" motive (Pet. 9), the question of his motive is made relevant only by his attenuated argument (Pet. 10-11) based on the

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[3] Taxpayer unaccountably contends that the record is devoid of evidence to support this statement as to his reasons for the 1961 payments (Pet. 9, n. 4). The finding is supported, however, by the testimony of his own witness (R. 128-130).

axiom that it is the net effect of a planned, integrated transaction which is determinative for income tax purposes, and that the component parts or steps have no independent tax significance. See, *e.g.*, *Commissioner* v. *Court Holding Co.*, 324 U.S. 331. If, by any stretch of the imagination, an "interest" payment in 1954 could be considered part of a single, planned transaction including repayment of loans in 1961, the fact that the latter was not planned from the outset, but resulted only from the intervening *Knetsch* decision, would preclude taxpayer's argument. With respect to taxpayer's assertion (Pet. 10) that he may lawfully adjust his affairs in the light of a change in law, the point may be conceded. The obstacle confronting taxpayer is that such adjustments may not be given retroactive effect.

3. Taxpayer maintains that the state of the law is "hopelessly confused" in respect to the "subject annuity transactions" and that this Court's decision in the *Knetsch* case must be implemented by "needed guide-lines" (Pet. 15-16). Contrary to his assertion, the question whether such tax-reduction transactions can be successfully employed presented no real problem either before or after the *Knetsch* case. As this Court noted in its opinion (364 U.S. at 366, n. 4), all of the prior decisions had been against taxpayers except in the Fifth Circuit, and the *Knetsch* rule has been applied without difficulty in numerous subsequent cases.[4] The whole theory of this type of trans-

[4] *United States* v. *Roderick*, 290 F. 2d 823 (C.A. 5); *Lovett* v. *Commissioner*, 37 T.C. 317, pending on appeal (C.A. 5); *Helwig* v. *Commissioner*, 37 T.C. 1046; *Gerstell* v. *Commis-*

action precludes any substantial non-tax economic benefit from remaining in the annuity transaction, and consequently the courts have not found any up to this point. Future cases will be decided, as this one was, on the basis of what happened as of the taxable year involved and not on the basis of what happened more than six years later.[5]

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*sioner*, decided July 30, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,181), pending on appeal (C.A. 3); *Carpenter* v. *Commissioner*, decided July 25, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,176), pending on appeal (C.A. 3); *Anderson* v. *Commissioner*, decided June 25, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,152); *Salley* v. *Commissioner*, decided April 10, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,080), pending on appeal (C.A. 5); *Estate of Polacek* v. *Commissioner*, decided March 7, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,048), appeal dismissed (C.A. 9); *Estate of Bennett* v. *Commissioner*, decided November 29, 1960 (1960 P-H T.C. Memorandum Decisions, par. 60,253); *Unilectric, Inc.* v. *United States* (E. D. Wisc.), decided April 28, 1961 (7 A.F.T.R. 2d 1319).

[5] Taxpayer represents (Pet. 11, n. 10) that there are many cases which have been stayed pending disposition of this case. No cases have been cited by him, however, and we are not aware of any.

## CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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